

IT 98-12

Tax Type: INCOME TAX

**Issue: Dividends of Non-Unitary Subsidiaries, Dividends of Foreign Subsidiaries,
Dividends Received From Unrelated Corporations
Section 78' Gross-Up Amount Should Be Included in the Sales Factor**

**STATE OF ILLINOIS
DEPARTMENT OF REVENUE
ADMINISTRATIVE HEARINGS DIVISION
CHICAGO, ILLINOIS**

**THE DEPARTMENT OF REVENUE
OF THE STATE OF ILLINOIS,
Petitioner**

v.

**"IRONCLAD" CORPORATION,
Taxpayer**

No. 95-IT-0000

FEIN: 13-0000000

**Linda K. Cliffel
Administrative Law Judge**

RECOMMENDATION FOR DISPOSITION

SYNOPSIS:

This case involves "Ironclad" Corporation ("Ironclad" or "taxpayer") and certain of its affiliates, which filed combined returns in Illinois for the tax years ending December 31, 1990 through December 31, 1992. On April 25, 1995, the Department of Revenue issued a Notice of Deficiency against the taxpayer in the amount of \$397,248, including interest and penalties. "Ironclad" timely protested this Notice of Deficiency on May 5, 1995. In addition, taxpayer has filed an amended return for the tax year ending December 31, 1990. On August 22, 1996, the Department of Revenue issued an additional Notice of Deficiency against the taxpayer in the

amount of \$1,625 taking into account the amended return. "Ironclad" timely protested this Notice of Deficiency on August 22, 1996.

At issue is whether, pursuant to Section 304(a)(3)(B)(ii) of the Illinois Income Tax Act,¹ dividends of non-unitary subsidiaries, dividends of foreign subsidiaries, dividends received from unrelated corporations, and the Section 78² gross-up amount should be included in the sales factor.³

On consideration of these matters, it is recommended that these issues be resolved partially in favor of the taxpayer and partially in favor of the Department.

FINDINGS OF FACT:

1. "Ironclad" Corporation ("Ironclad") and certain affiliated corporations conducted a unitary business: manufacturing, distributing and marketing security equipment, smoke alarms, fire control systems, plastic caps and closures; contract packaging of personal care products; radio-transmitted security monitoring systems; and other activities related to such products or services. (Stip.¶8⁴) "Ironclad" is a Delaware corporation with its principal place of business in Chicago, Illinois. (Stip. ¶7)

2. During the years at issue, "Ironclad" received the following dividends from the subsidiaries and affiliates at issue here:

¹ Unless otherwise noted, reference to sections are to the Illinois Income Tax Act, 35 ILCS 5/101 et seq.

² Section 78 of the Internal Revenue Code. "Section 78 gross-up" refers to a federal income tax concept whereby a hypothetical dividend amount is created in order to ensure that the proper amount of foreign tax credit is claimed.

³ Taxpayer protested the imposition of Section 1005 penalties, however this issue was not included in the pretrial order nor was evidence introduced regarding reasonable cause.

⁴ "Stip." refers to the Amended Stipulation of Facts dated August 22, 1997.

	1990	1991	1992
"Readsalot"	\$23,165,634	\$9,183,189	\$4,429,354
"Cinque"	850,000	1,500,000	
Foreign Subs	666,022		1,033,819
Minority Holdings			158,641
§78 Gross-up	268,778		521,249
Total	\$24,950,434	\$10,683,189	\$6,143,063

(Stip. ¶5)

3. For the audited tax years, "Ironclad" owned 100% of the stock of "Readsalot" Publishing, Inc. ("Readsalot"). (Stip. ¶9)

4. "Readsalot" was engaged in the business of publishing controlled circulation trade magazines. (Stip. ¶9) "Readsalot" was not a member of the "Ironclad" unitary group, either as reported by the taxpayer or as determined by the Department per audit. (Stip. ¶12)

5. For the 1990 and 1991 tax years, "Ironclad" owned "Cinque" Delivery Services ("Cinque"). "Cinque" was sold by "Ironclad" in August, 1991. (Stip. ¶10)

6. "Cinque" was engaged in the courier business. (Stip. ¶10) "Cinque" was not a member of the "Ironclad" unitary group, either as reported by the taxpayer or as determined by the Department per audit. (Stip. ¶12)

7. Taxpayer owned certain foreign subsidiaries that engaged in similar business activities as "Ironclad". Taxpayer's management was not involved in the day-to-day management of the foreign subsidiaries, but taxpayer's management was consulted about important business decisions and reviewed financial results. Taxpayer's activities in relation to its foreign subsidiaries consisted primarily of holding the stock and receiving dividends. (Stip. ¶11)

8. The dividends identified as minority holdings were preferred stock dividends received by "Ironclad" from unrelated corporations. The taxpayer's activities in relation to the preferred stock

dividends consisted of receiving the dividends and limited investment decision-making in Illinois.
(Stip. ¶13)

9. The Department conducted a reaudit regarding the 1990 IL 1120-X, of "Across the Board Condominium Division" ("ABCD") and certain dividend adjustments. The Department conceded the "ABCD" partnership issue and certain intra-group dividend adjustments were incorrect. The reaudit resulted in changes to the proposed assessment that were supported by revised audit schedules. (Stip. Ex. No. 6) The revised proposed assessments are as follows:

<u>Tax Year Ending</u>	<u>Revised Proposed Assessment</u>
12/31/90	\$39,251
12/31/91	(65,625)
12/31/92	(7,764)

CONCLUSIONS OF LAW:

The primary issue in this matter is whether certain dividend income that is not included in Illinois base income is included in the sales factor.

Resolution of the issue in this case requires an interpretation of the sections of the statute which determine the tax liability of multijurisdictional corporations. Section 201(a) imposes a tax on the "net income" of every corporation that earns income within the state. Section 202 defines "net income" for a taxable year as being "that portion of . . . base income for such year . . . which is allocable to this State under the provisions of Article 3."⁵

For corporations, the term "base income" is defined in Section 203(b)(1) as being the corporation's taxable income as modified by Section 203(b)(2). "Taxable income" means "taxable income properly reportable for federal income tax purposes for the taxable year under the provisions of the Internal Revenue Code," according to Section 203(e)(1).

For purposes of calculating federal taxable income, 100% of dividends received by a corporation from a member of the same affiliated group is deducted in arriving at taxable income. The dividends which were received by "Ironclad" from "Readsalot" and "Cinque", therefore, would not have been included in federal taxable income and, therefore, were not included in "Ironclad"'s base income for Illinois income tax purposes.

Section 203(b)(2) of the Illinois Income Tax Act modifies taxable income, in part, by subtracting the Section 78 gross-up amount and the amount of dividends received from non-U.S. affiliated corporations⁶, which were included in federal taxable income.

In the case of a corporation which operates in more than one state, Section 304(a) prescribes an apportionment formula to determine a percentage which is applied to the business income of the corporation from both within and without the state to arrive at the portion of income subject to Illinois income tax. The apportionment formula separately compares the corporation's in-state and out-of-state sales, property and payroll. Once separate factors have been calculated for in-state sales, property and payroll, the sales factor is doubled and added to the property and payroll factors, the sum of which is then divided by 4 to determine the percentage that will be applied to the taxpayer's business income to determine Illinois taxable income. Caterpillar Tractor Co. v. Lenckos, 84 Ill.2d 102, 123 (1981).

The apportionment factor at issue in this case is the sales factor. The term "sales" is defined in Section 1501(a)(21) to mean "all gross receipts of the taxpayer not allocated under Sections 301, 302 and 303."

Section 301(c), in relevant part, reads as follows:

⁵ 35 ILCS 5/301 - 308

⁶ 35 ILCS 5/203(b)(2)(G) and 35 ILCS 5/203(b)(2)(O).

(c) Other persons. (1) In general. Any item of income or deduction which was taken into account in the computation of base income for the taxable year by any person other than a resident and which is referred to in Section 302, 303, or 304 (relating to compensation, nonbusiness income and business income, respectively) shall be allocated to this State only to the extent provided by such section. (2) Unspecified items. Any item of income or deduction which was taken into account in the computation of base income for the taxable year by any person other than a resident and which is not otherwise specifically allocated or apportioned. (emphasis added)

A long-standing rule of statutory construction that applies to this case is that taxing statutes are to be strictly construed. The language of the statute may not be extended or enlarged by implication and in cases of doubt the language is construed in favor of the taxpayer and against the Department. Van's Material Co. v. Department of Revenue, 131 Ill.2d 196 (1989).

To be included within the sales factor, the non-unitary dividends, the foreign dividends and the Section 78 gross-up must fit within the statutory definition of "sales." Sections 301(c)(1) and (2) refer to items of income "taken into account in the computation of base income." To be included within the meaning of the definition of "sales" in Section 1501(a)(21), the non-unitary dividends, Section 78 gross-up and the foreign dividends which are excluded from taxable income either pursuant to Section 243 of the Internal Revenue Code or under Sections 203(b)(2) subparagraphs (G) and (O) would have to be "taken into account in the computation of base income for the taxable year."

The phrase "taken into account" is not defined in the statute. It was, however, addressed by the U.S. Supreme Court in American Bank & Trust Co. v. Dallas County, 463 U.S. 855 (1983), wherein the court interpreted the federal statute that prohibits state or local taxation of federal obligations or interest paid thereon. The statute provided that the prohibition "extends to every form of taxation that would require that either the obligations or the interest thereon, or both, be considered, directly or indirectly, in the computation of the tax." *Id.* at 862. The court stated that

"In context, the word 'considered' means taken into account, or included in the accounting." (*Id.*) The Section 78 gross-up amount, the nonunitary dividends, and the foreign dividends at issue in this case are not "taken into account" in computing base income. They are excluded from base income. Therefore, they do not come within the statutory definition of "sales," and for that reason they cannot be included in the sales factor.

Although there are no precedents in Illinois case law dealing with the issue of whether subtraction modification items described in Section 203(b)(2) subparagraphs (G) and (O) are includable in the sales factor, there is case law dealing with the issue of whether the subtraction modification described in Section 203(b)(2)(J) is includable in the sales factor and it is controlling on the issue at hand. In considering the application of the decisions in these cases to this issue, it is important to keep in mind the purpose of the apportionment formula which is described in the lead case as follows: "[T]he purpose of the apportionment formula is to confine the taxation of business income to that portion which is attributable to activities in Illinois." Continental Illinois National Bank v. Lenckos, 102 Ill.2d 210, 224 (1984), (quoting from Caterpillar Tractor Co. v. Lenckos, 84 Ill.2d 102 (1981)).

In Continental Illinois National Bank, the taxpayer deducted from base income interest it had received on obligations of the U.S. Government pursuant to Section 203(b)(2)(J). The Department included this interest in the sales factor even though it was not included in base income. The court found that by including the interest received on the U.S. obligations in the apportionment formula, the Department was doing indirectly what it could not do directly, i.e., taxing income that was exempt by statute. The court also noted that it is illogical to assume that the legislature would design an apportionment formula to apportion income to be taxed by the Department, which includes income that is exempt from tax. Relying on American Bank & Trust

Co. v. Dallas County, the court held that "tax exempt interest on obligations of the United States may not be taken into consideration in apportioning taxable income." 102 Ill.2d at 225.

In this case, as in Continental, the Department is including in the apportionment factor income that is subtracted from taxable income to arrive at Illinois base income. In the Continental case, the subtraction was a modification set forth in Section 203(b)(2)(J). In this case, the subtractions are either a deduction mandated by the federal income tax code or modifications set forth in Sections 203(b)(2)(G) and (O). The consequences are the same in this case as in the Continental case. The Department is attempting to tax indirectly the dividends and the Section 78 gross-up amount, which it cannot tax directly. As the court said in the Continental case, "[I]t is illogical to assume that the General Assembly would devise a formula to measure taxable income which includes income that is clearly tax exempt." 102 Ill.2d at 224. The issue presented in this case is identical to the issue decided with regard to the apportionment formula in the Continental case. Therefore, the result must be the same.

Further, in General Telephone Co. v. Johnson, 103 Ill.2d 363 (1984), the Illinois supreme court reviewed the legislature's adoption of the waters' edge combined apportionment method following Caterpillar Tractor Co. v. Lenckos, 84 Ill.2d 102 (1981), where the court had allowed world-wide combination. In analyzing the legislative history, the court wrote:

The legislature rejected worldwide combined apportionment, however, and instead adopted a domestic version which excludes from the unitary business group any member whose activities are carried on primarily outside of the United States. The domestic combined apportionment also strictly limits formulary consideration of foreign dividend income as well as sales between United States and foreign members of the same unitary group. 103 Ill.2d at 373.

It appears that this language means that foreign source dividends from subsidiaries of U.S. companies cannot be included in the sales factor to indirectly tax excluded foreign dividend

income. The Department's interpretation herein would allow the Department to tax indirectly income that it cannot tax directly contrary to the opinion in Continental Illinois National Bank v. Lenckos, 102 Ill.2d 210 (1984).

The Department states that the calculation of the sales factor is separate and distinct from the calculation of base income, citing Miami Corp. v. Department of Revenue, 212 Ill.App.3d 702 (1st Dist. 1991). The Department also states that the sales factor is based on receipts, not income. However, the case does not support the Department's position on the sales tax factor calculation. That case involved a company that had its commercial domicile in Illinois and owned real estate in Louisiana, Oregon and Florida. The taxpayer derived revenue from land owned in Oregon and Miami from the sale of timber rights. The taxpayer derived its income from the land in Louisiana from contracts with independent companies that explore, drill and produce oil and gas from reserves on taxpayer's property. The Department attempted to assess income tax based on the standard three-factor formula of sales, property and payroll using gross dividends and income (rather than gross receipts) in the sales factor. The court held that the Department's approach grossly distorted the taxpayer's income producing activities apportioned to Illinois and that, because of the nature of taxpayer's business, separate accounting rather than apportionment was the appropriate method to use to determine the portion of income taxable by Illinois. The case does not support the Department's argument that the dividends and Section 78 gross-up which are excluded from base income are properly includable in the apportionment formula.

The calculation of the sales factor is distinct from the calculation of taxable income, but that does not mean that the sales factor can include gross receipts that are not included in the determination of taxable income. Continental Illinois National Bank v. Lenckos and General Telephone Co. v. Johnson determined that income items that are excluded from base income by

statute are not includable in the sales factor. The Department has cited no authority that would indicate that the principles set forth in Continental Illinois National Bank v. Lenckos, and General Telephone Co. v. Johnson, are not controlling here.

Taxpayer has argued that the dividends and Section 78 gross-up should not be included in the sales factor since they are not items of business income. Since I find that items must be included in base income in order to be included in the sales factor, it is unnecessary for me to address taxpayer's constitutional arguments.

A secondary issue is whether the dividends received from minority holdings should be included in the sales factor. These dividends would be included in base income since they are neither an intercompany elimination, a deduction from federal taxable income pursuant to §243 of the Internal Revenue Code, nor an Illinois subtraction modification. According to Section 304(a)(3)(C) of the Illinois Income Tax Act, sales of other than tangible property are to be included in the numerator of the sales factor when the income-producing activity is performed within the state, or when the income-producing activity is performed both within and without the state and the greater proportion of the income-producing activity is performed within the state.

The Department of Revenue has made a *prima facie* showing that these dividends are includable in the numerator of the sales factor by the introduction of the NOD.⁷ The stipulations of fact state only that limited investment decisions regarding the minority holdings are made within Illinois; no evidence has been introduced regarding where any other income-producing activity occurred. Taxpayer, therefore, has failed in its burden of proof to rebut the Department's *prima facie* case, and therefore, the dividends from minority holdings should be included in the numerator of the sales factor.

⁷ 35 ILCS 5/902(c).

WHEREFORE, for the reasons stated above, it is my recommendation that the Notice of Deficiency should be revised to exclude from the calculation of the sales factor all dividends received from "Readsalot" Publishing, Inc. and "Cinque" Delivery Services, all dividends from foreign subsidiaries, and the Section 78 gross-up amount.

Date:

Linda K. Cliffl
Administrative Law Judge